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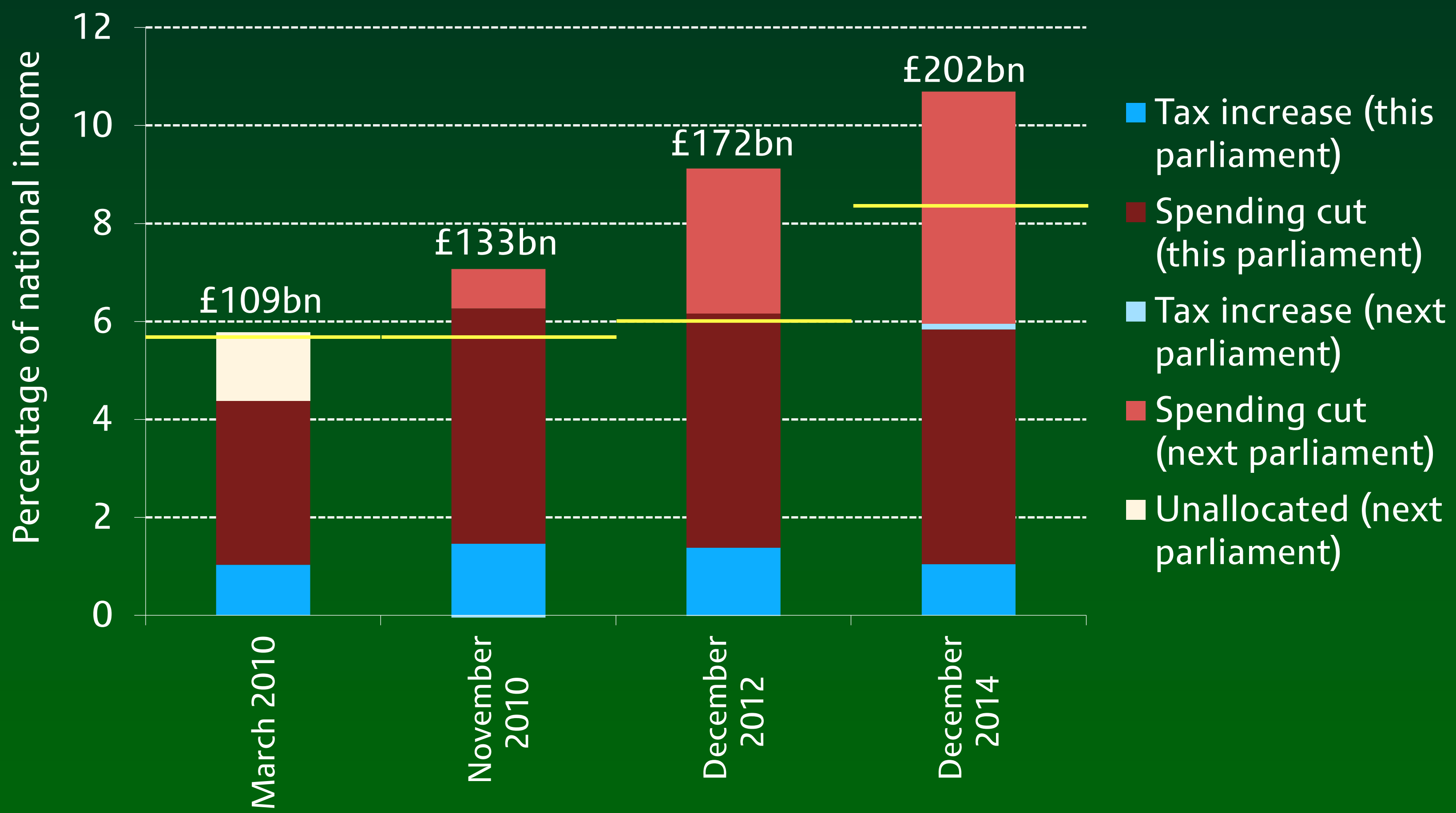
Public finances: the consolidation so far, and a dicey decade ahead?

Carl Emmerson

Underlying weakness in the public finances and the fiscal response



Yellow line shows the estimated underlying increase in structural borrowing since March 2008.
Notes and sources: see Figures 1.3 to 1.6 of *The IFS Green Budget: February 2015*.

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The December 2014 plan: up to 2014–15

- £110bn of fiscal tightening measures implemented
  - 82% from spending cuts and 18% from net tax rises
- £27bn more than planned in Labour's March 2010 Budget
  - roughly the same magnitude of net tax rise
  - £15bn greater social security cuts
  - £18bn of additional cuts to other day-to-day public spending
  - £6bn smaller cut to investment spending

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The December 2014 plan: beyond 2014–15

- £92bn of further fiscal tightening to come
  - so on this measure 55% done 45% to do
- Most to come from cutting day-to-day public spending
  - small net tax rise and small cut to investment spending relative to pre-crisis baseline (latter still less than that implied by March 2010 Budget)
  - £6bn of further social security cuts from measures already place
  - £81bn of further cuts from day-to-day public spending as a share of national income to be found
  - 98% from spending cuts and 2% from net tax rises
- Overall the plan from 2010–11 to 2019–20 comprises 89% spending cuts and 11% net tax rises

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The December 2014 plan: international comparison

- Comparison of IMF forecasts for structural borrowing in 32 advanced economies shows that the UK is forecast to have:
  - the 4th largest structural borrowing at the peak during the crisis
  - implemented the 7th largest consolidation up to 2015
  - (essentially) the 2nd largest structural borrowing in 2015
  - the largest planned fiscal consolidation between 2015 and 2019
  - the 18th largest (or 15th smallest) structural deficit in 2019

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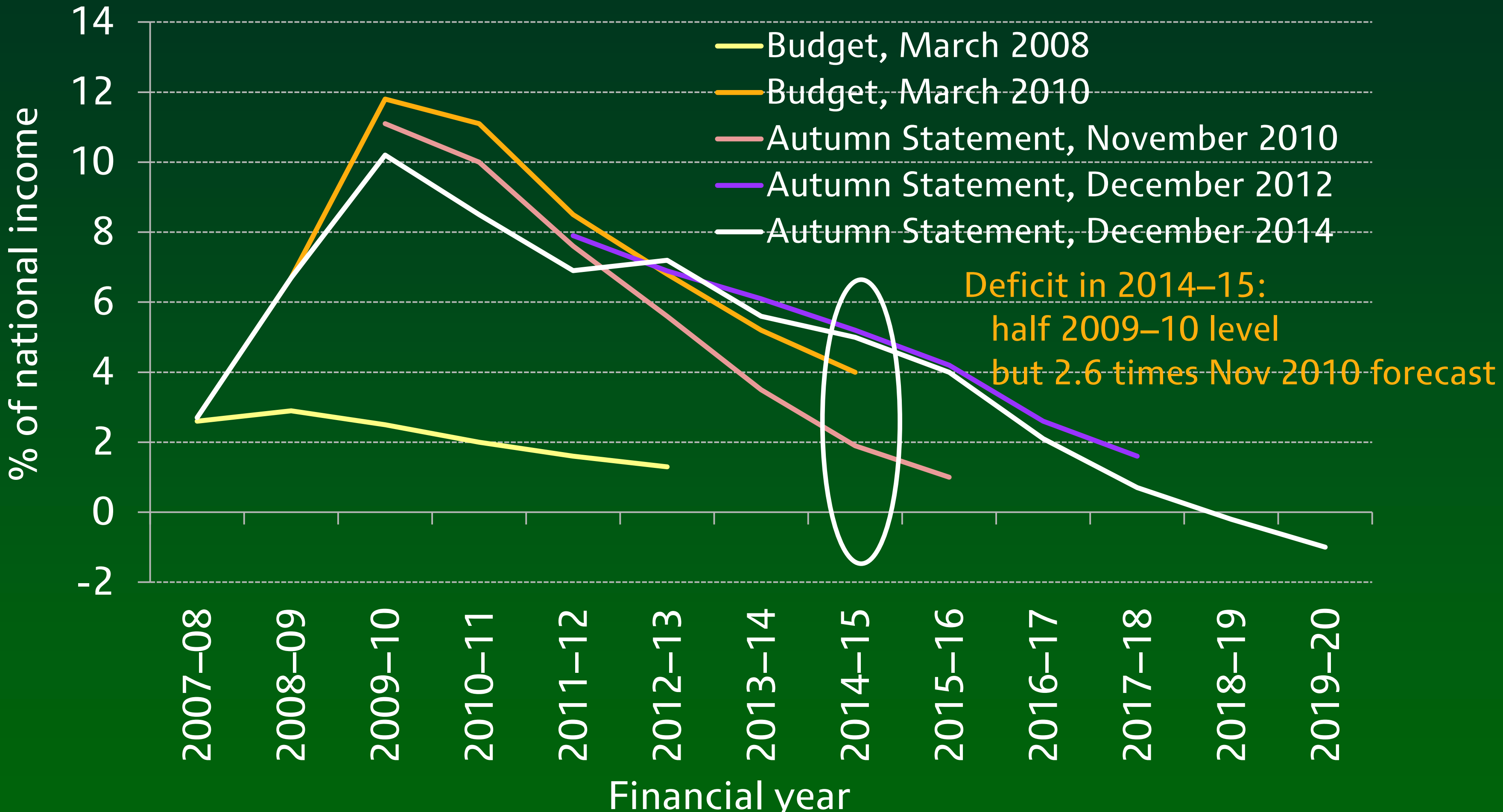
Successive forecasts for borrowing



Notes and sources: see Figure 1.1b of *The IFS Green Budget: February 2015*.

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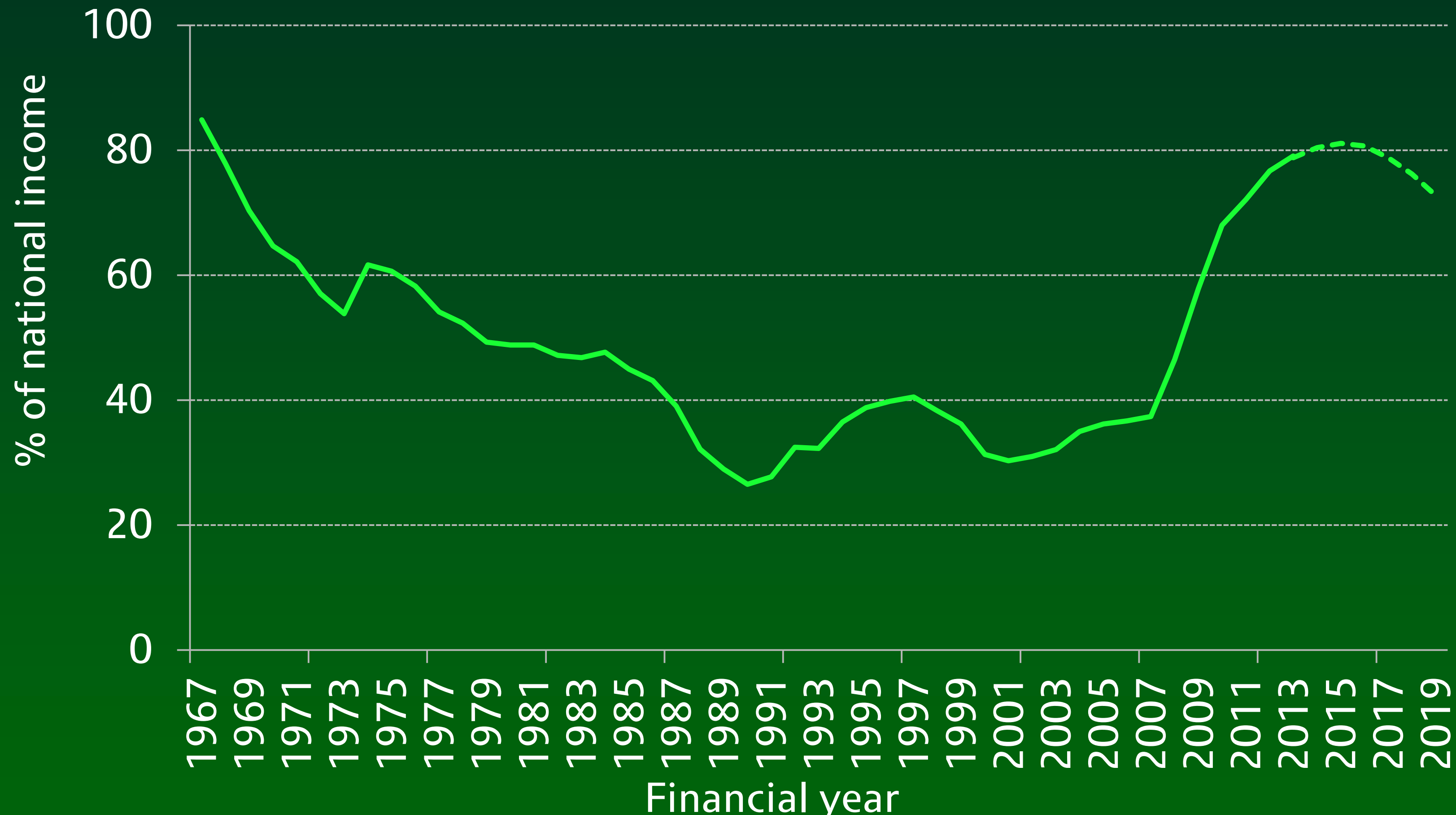
Public sector debt high by recent historical standards



Notes and sources: see Figure 5.2 of *The IFS Green Budget: February 2015*.

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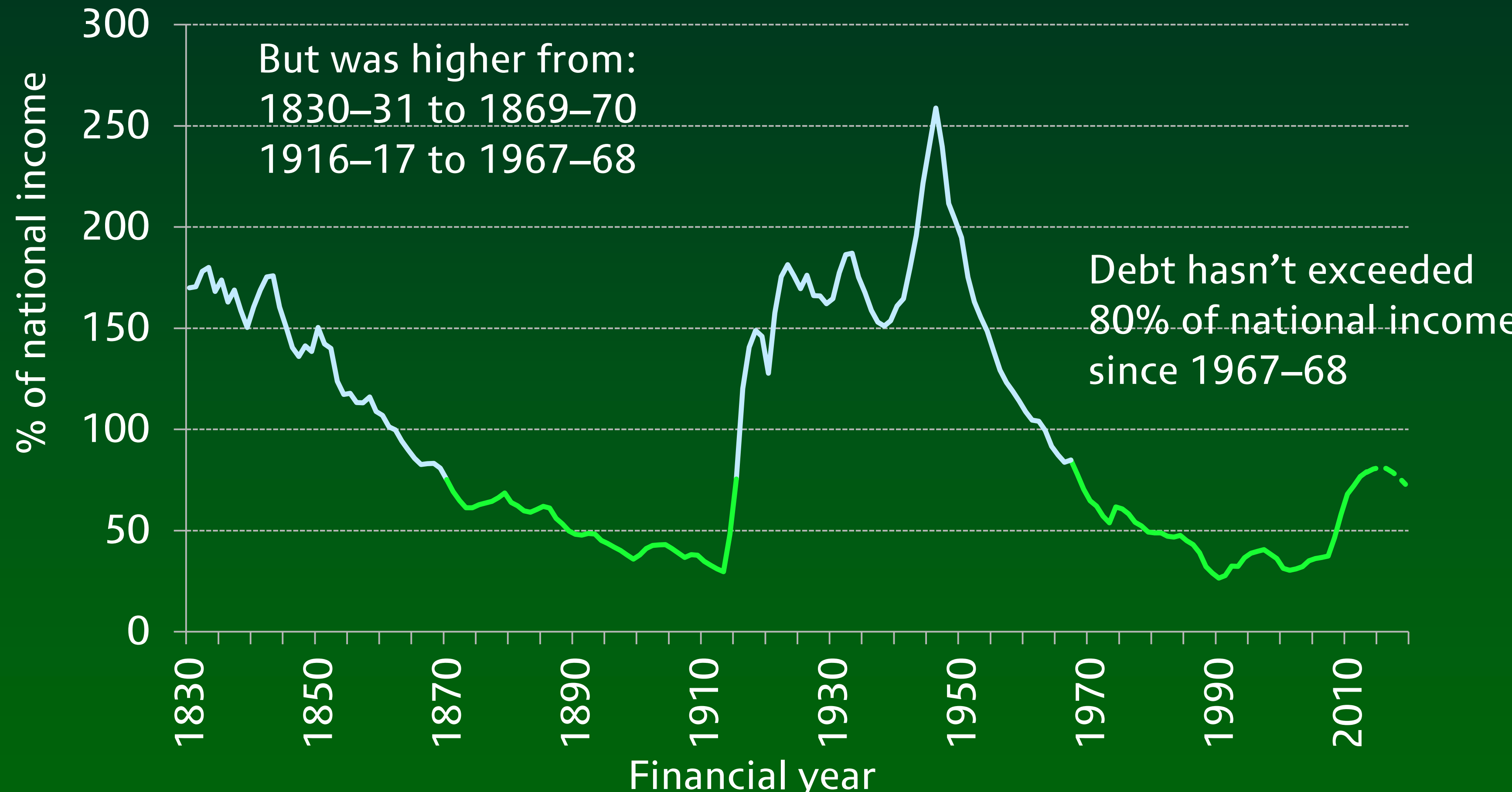

Notes and sources: see Figure 5.2 of *The IFS Green Budget: February 2015*.

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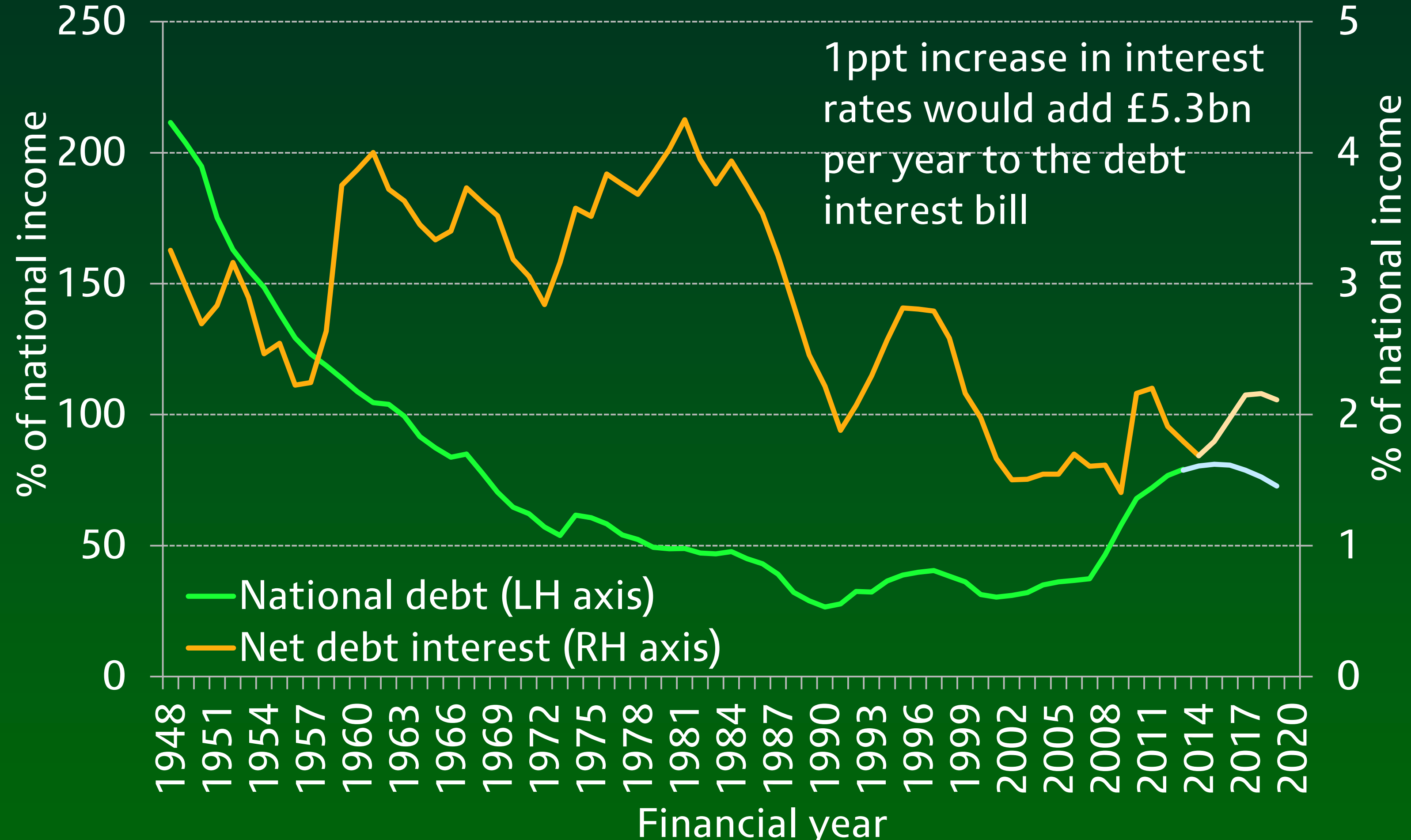

Notes and sources: see Figure 5.2 of *The IFS Green Budget: February 2015*.

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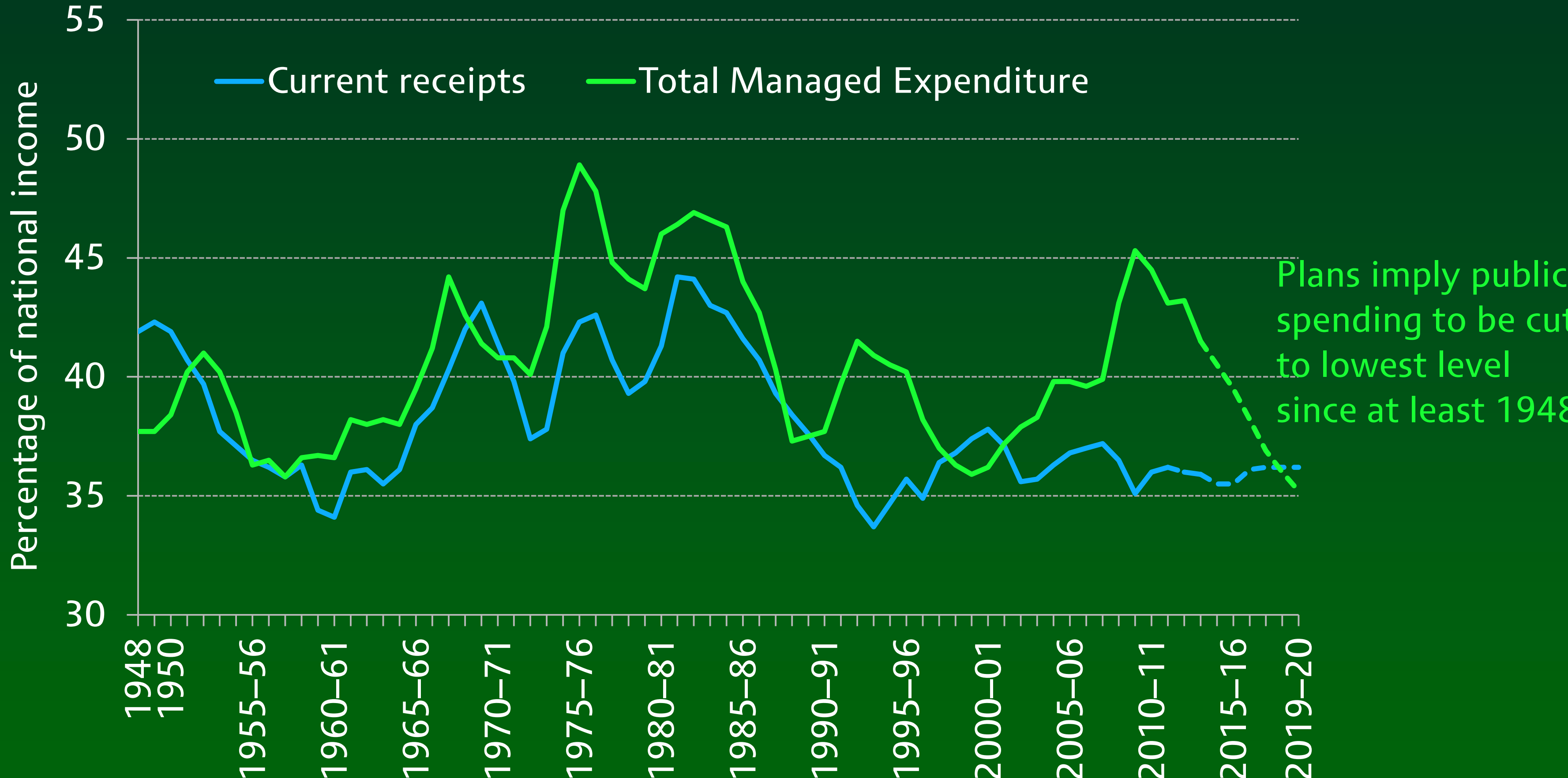
Debt: the parties' plans

- Three main UK parties have fiscal rules which require debt to fall as a share of national income
- If throughout 2020s you achieve:
  - 1% of national income budget surplus: debt/GDP 27 percentage points (ppts) lower
  - balanced budget: 19ppts lower
  - balanced current budget, maintain investment spending: 9ppts lower

Forecasts for receipts and spending



Notes and sources: see Figure 5.1 of *The IFS Green Budget: February 2015*.

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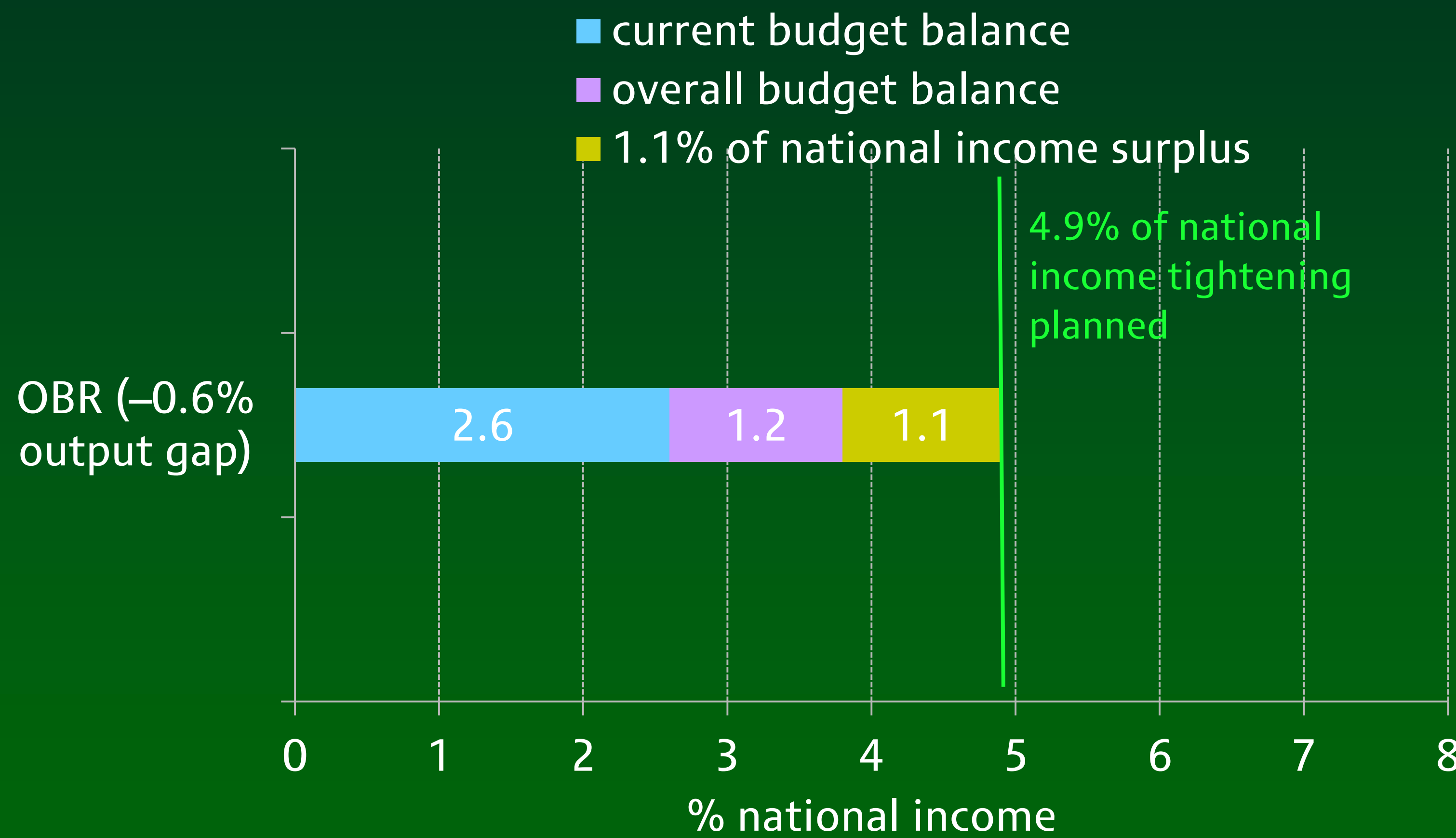
How large a fiscal consolidation is required?

Estimated fiscal tightening beyond 2014–15 to achieve structural:



Notes and sources: see Table 5.2 of *The IFS Green Budget: February 2015.*

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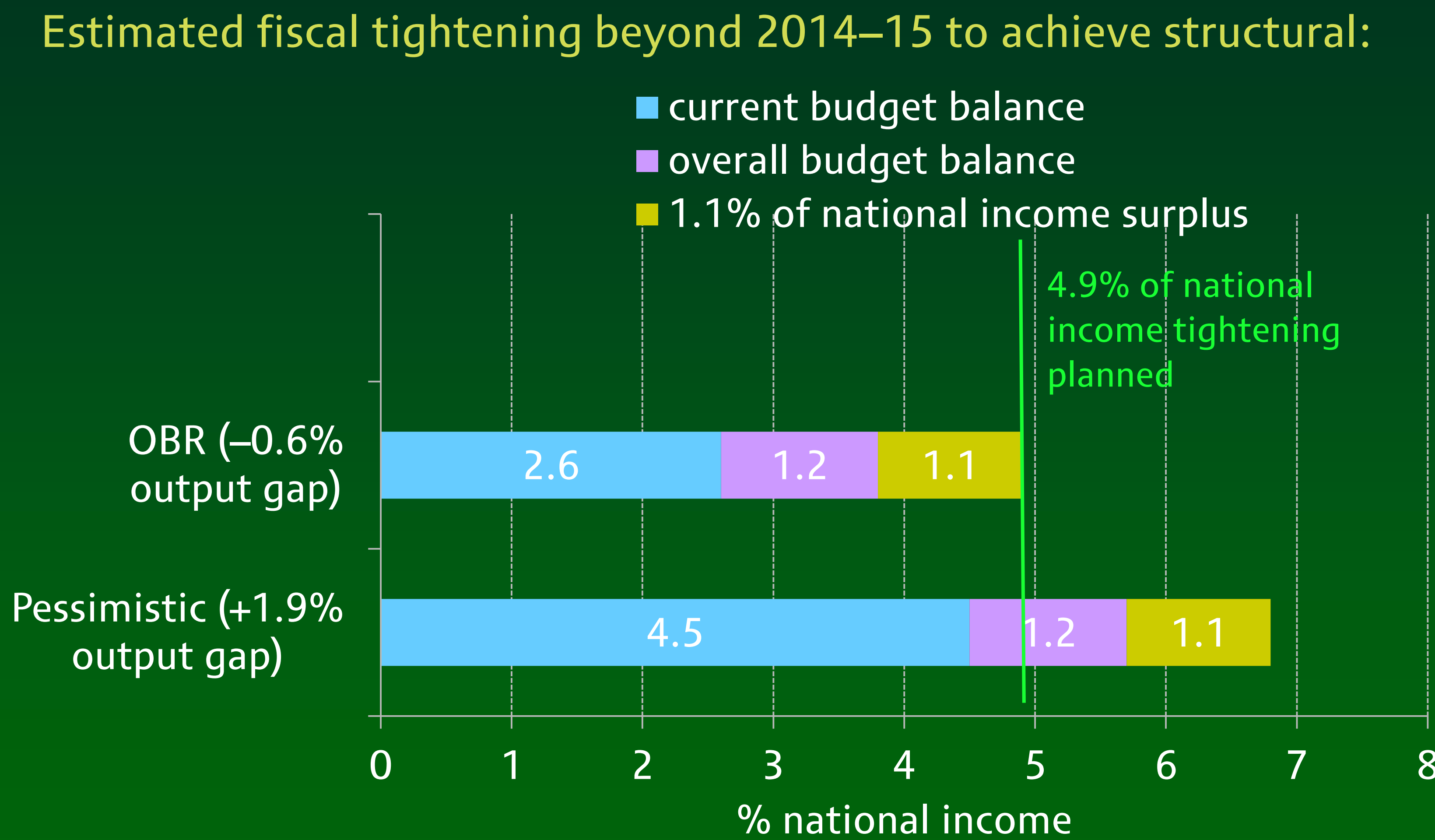

Notes and sources: see Table 5.2 of *The IFS Green Budget: February 2015.*

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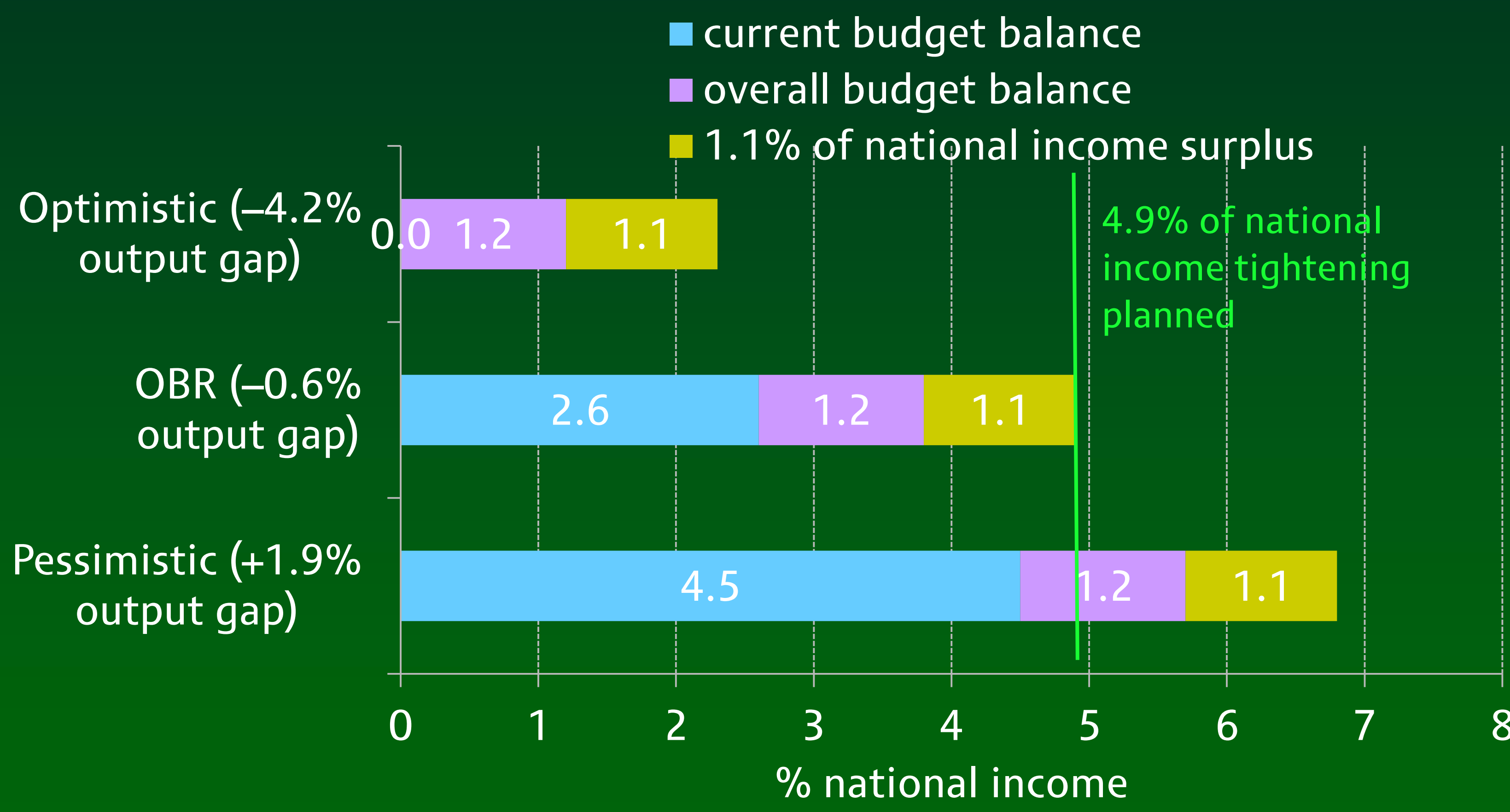

Notes and sources: see Table 5.2 of *The IFS Green Budget: February 2015.*

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Cutting spending and keeping it down difficult

- Implied cuts are large
  - 2009–10 to 2014–15 already represents longest and deepest period of consecutive cuts to public service spending per head since WW2
- Additional pressures in next parliament
  - easiest cuts presumably done first
  - public sector wage restraint harder when private sector wages rising
  - public service pensions to cost public sector employers £4.7 billion per year more due to recent revaluation and increased employer NICs
- Longer-term pressure: ageing population
  - even with optimistic assumptions over health spending, projected to add 3.9% of national income to spending over next fifty years
- New “welfare cap” could reduce unanticipated increases in social security spending

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Risks in forecasts for receipts

- Three risks to revenue forecasts
  - growth will differ from the forecast
  - composition of growth will differ from the forecast
  - policy will be changed

Composition of growth will differ from the forecast

- Receipts of income tax and NICs affected by the composition as well as the level of aggregate employment income
- Recent years have demonstrated this
  - aggregate employment income growth, 2009–10 to 2015–16,
    - June 2010: 29.1%
    - December 2014: 21.1%
  - receipts £26.2bn lower because of lower aggregate employment income
  - in addition, different composition of growth (more employment, lower earnings) reduced revenues by further £6.5bn
- Recent reforms have slightly increased sensitivity of revenues to how growth is distributed
  - income tax has been made more progressive
  - increased reliance on capital taxes

Policy risk: upside risk for revenues

- General elections
  - with notable exception of spring 1992, pre-election budgets appear relatively restrained
  - recent history suggests elections associated with a subsequent boost to government revenues (1992, 1997, 2001, 2005, 2010)

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Policy risk: downside risks risk for revenues

- Forecasts assume rates of fuel duties indexed in line with the (discredited) RPI
  - recent history suggests this won't happen: 5-year cash freeze would cost £4.1bn in 2019–20, CPI-indexation would cost £1.8bn
- Income tax personal allowance and higher-rate threshold CPI uprated
  - we estimate 5.1 million higher-rate taxpayers in 2015–16, fiscal drag increases this by 1.2 million in 2020–21 and by 2.8 million in 2025–26
- Some thresholds frozen in cash terms
  - £100k and £150k income tax thresholds
  - £50k and £60k child benefit takeaway thresholds:
    - we estimate 1.2m families lose some/all child benefit in 2015–16
    - fiscal drag would result in 50% increase by 2020–21
    - and a more than doubling by 2025–26

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Summary (1/2)

- Much fiscal tightening done, plans imply almost as much to do
  - £110bn of fiscal tightening measures implemented; 82% from spending cuts and 18% from net tax rises
  - plan implies £92bn of further fiscal tightening to come; 98% from spending cuts and 2% from net tax rises
- Additional tightening due to downgrade in borrowing forecasts between 2010 and 2012 and Chancellor's desire for budget surplus
- Debt high by recent historical standards
  - explains desire from all three main UK parties to ensure it falls, albeit at different speeds
  - balanced budget would reduce debt by 19% of national income after ten years compared to a 9ppt fall from a balanced current budget

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Summary (2/2)

- The amount of spare capacity in the economy is one key risk
  - could be much less – or more – need for austerity if a budget surplus is to be brought about
- Deep spending cuts are another risk
  - can spending plans be delivered, and if so could spending be held down to such historically low levels?
- Revenues have disappointed in this parliament and could do again
  - strong employment growth coupled with very weak earnings growth has been bad for tax receipts
- Future policies will also affect revenues
  - will RPI indexation of fuel duties actually happen?
  - will more individuals face higher and additional rates of income tax?
  - will more and more families have their child benefit withdrawn?

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